Deal Points

The Newsletter of the Mergers and Acquisitions Committee

FEATURE ARTICLE

Buyer Beware: Reduced Indemnity on Account of Supposed (Mythical?) Tax Benefits

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When the seller of a business or the assets of a business is negotiating the scope of its liability to indemnify the buyer for a breach of any of the representations and warranties ("representations," for the sake of brevity) the seller will give in connection with the sale, it routinely negotiates for deductibles and other "baskets," minimum levels of eligible claims, limits on liability or "caps," and short survival periods during which claims can be brought. The effect of those provisions is to limit the seller's liability to indemnify the buyer for a breach of the seller's representations. A seller also often seeks, and frequently obtains, an agreement from the buyer to offset or reduce the amount of the seller's indemnity obligation by the amount of the tax benefits realized or realizable by the buyer as a result of the facts and circumstances underlying the breach of representation for which indemnification is sought.

The Seller's Basic Tax Benefit Offset Argument

The theme of the seller's tax benefit offset argument is basically that it is unfair to the seller to allow the buyer to receive a gross indemnification payment and also to be able to enjoy the tax benefit arising from the circumstances upon which the buyer's indemnification claims are based. For example, if the seller has represented that there are no closing date liabilities other than those disclosed, but it is later discovered that there was an undisclosed pre-closing payable of $1000, the buyer would have a breach of representation claim for $1000. If the seller paid the buyer a $1000 indemnification payment because of this claim, the seller argues that the buyer could also claim an expense deduction of $1000 on its income tax return with respect to this pre-closing liability that would save the buyer (at the 35% rate) $350 of federal income tax. The net result according to the seller is that the buyer would receive not

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only an indemnification payment of $1,000 to cover the full pre-closing liability; it also would receive a windfall because its federal income tax liability would be reduced by $350 because the buyer or the buyer subsidiary could deduct for income tax purposes the $1000 liability from its income. To rectify this inequity, the seller claims it is only fair that it be able to reduce or offset its indemnity obligation to the buyer by that tax windfall (*i.e.*, $350).

Analysis of Seller's Argument

The seller's basic argument has a certain equitable appeal, at least on the surface. The real question, however, is whether there is a legitimate expectation that the buyer has the right to claim a deduction for federal income tax purposes for pre-closing liabilities or negative conditions that would typically be covered by the seller's representations to the buyer. In other words, does the premise of the seller's argument that the buyer could obtain an unintended tax "windfall" hold up to scrutiny?[2]

General Discussion

There are two basic types of taxable acquisitions.[3]

The first type of taxable transaction involves an acquisition by the buyer of the assets of a target company, an acquisition by the buyer of the stock of a target company accounted for as an acquisition of assets pursuant to an election under section 338(h)(10) of the Internal Revenue Code of 1986, as amended (the "Code"), or a forward triangular merger of a subsidiary of the buyer and the target in which the target company is merged out of existence and which is accounted for as a purchase of assets of the target (collectively, an "Asset Deal"). The second type of taxable transaction involves a purchase by the buyer of the stock of the target company (without a section 338(h)(10) election) or a reverse triangular merger of a subsidiary of the buyer and the target in which the target company is the survivor (collectively, a "Stock Deal").

General Tax Accounting Rules

A pre-closing event or negative condition that would constitute a breach of a representation by the seller may in real terms constitute an unfavorable occurrence for the buyer, but that does not mean that the event or negative condition, in and of itself, will generate an expense that can be currently deducted by the buyer for federal income tax purposes. Certain post-closing expenditures by the buyer or a buyer subsidiary that are incurred to correct events or conditions that occurred prior to the closing, such as the misrepresented quantity or usable condition of inventory or machinery and equipment, would probably have to be capitalized by the buyer and would not be immediately deductible. Accordingly, those expenditures would not give rise to an immediate "tax benefit" that could be viewed as a potential tax "windfall."

Further, even if the misrepresented pre-closing event or condition does give raise to a deductible expense it does not follow that the expense would be deductible by the *buyer*. For an expense to be deductible as a trade or business expense by a taxpayer it must be an ordinary and necessary expense of *that* taxpayer's trade or business. If the expense was incurred in some other taxpayer's (*e.g.*, seller's) trade or business it will generally not be deductible by a different taxpayer (*e.g.*, the buyer) but may continue to be deductible by the first taxpayer.[4] Also, for an expense in respect of a liability to be deductible by a taxpayer generally all the events needed to establish liability must have occurred, the liability must be fixed and determinable, and economic performance (which generally means payment by the taxpayer) must have occurred with respect to the expenditure.[5]

The task then is to apply these general tax accounting rules to the types of transactions described above: taxable Asset Deals and taxable Stock Deals.

2 This article addresses United States federal income taxes only. Foreign, state, or local tax analysis is beyond the scope of this article.

3 This article will not cover acquisitions that are structured as tax-free reorganizations under one of the categories of transactions described in Section 368(a) of the Internal Revenue Code of 1986, as amended because the general accounting rules that apply to assumed liabilities and that could preclude a buyer or the target company from deducting an assumed liability by statute do NOT apply to transactions that qualify as a tax-free reorganization under Section 381(c) of the Code and the buyer or the target company acquired in the transaction should be entitled to claim the deduction. *VCA Corp. v. U.S.*, 566 F2d. 1192 (Fed. C. 1977); Rev. Rul. 83-73, 1983-1 C.B. 84. Therefore, a tax windfall to a buyer is quite possible in a tax-free reorganization, although since the buyer does not get a basis step-up for the acquired assets in a tax-free reorganization any arguable inequity the seller faces if it does not share the supposed tax "windfall" accruing to the buyer is probably off-set because the buyer has forgone the tax benefit of the basis step-up in the acquisition.

4 *Welch v. Helvering*, 290 U.S. 111, 113 (1933); *Deputy v. DuPont*, 308 U.S. 488, 494 (1940).

5 188 BNA Daily Report for Executives J-1, 2003, TREATMENT OF CONTINGENT LIABILITIES IN AN ACQUISITION EVOLVING (2003).

Asset Deals

Where the buyer or the buyer's subsidiary takes title to the assets of the purchased business and there is a breach of a seller's representation to the buyer because the buyer becomes subject to a liability or negative condition, the question is whether the expenditure in respect of such liability or condition is properly deductible by either the buyer or the seller. For an expense to be deductible by a taxpayer it must be an ordinary and necessary expense of the taxpayer's trade or business, the liability must be fixed and determinable, and economic performance (which generally means payment) by the taxpayer must have occurred with respect to the expenditure. If the misrepresentation by the seller concerns a liability or negative condition that was not fixed and determinable on or prior to the closing and thus could not have been deducted by the seller prior to the closing, the expenditure in respect of the liability or condition does not convert to one that could be deducted by the buyer. Under existing case law, any liability that is assumed by the buyer in the purchase of the assets of a business must be capitalized into the cost of the acquisition and that liability may not be deducted by the buyer.[6] If a liability was a contingent liability at the closing and did not become fixed and determinable until after the closing, that liability could still not be deducted by the buyer.[7] The fact that the buyer will be precluded from claiming a deduction for an assumed liability will be the result whether the assumed liability is fixed and determinable or is contingent, whether it is identified, or not identified, or whether the liability is known or unknown at the time it is assumed.[8]

Thus, in an Asset Deal, it is difficult to see the merit from a tax point of view of a seller's argument that a buyer will have a potential tax windfall from the indemnified expenditure that should be reflected as a reduction of seller's indemnity payment.

Stock Deals

In a taxable Stock Deal the target company remains in existence as a separate entity following the closing and generally should retain the ability to deduct on its tax return for the appropriate tax year an expenditure that arises from the circumstances underlying a breach of representation, whether the liability was a fixed and determinable liability that was properly accrued prior to the closing or was a contingent liability that was properly accrued after the closing. This type of transaction does not involve the disqualifying element of a "new" taxpayer trying to claim a deduction that is attributable to another taxpayer's trade or business, which is one of the problems that can arise in an Asset Deal as discussed above. However, if the target company was a member of the seller's affiliated group and was included on the consolidated return filed by that group prior to the Stock Deal, the target company could be precluded from deducting after the closing an expenditure in respect of the misrepresented liability or negative condition if the deduction was properly accrued for tax purposes prior to the closing. If that deduction was properly accrued for tax purposes prior to the closing, it should be claimed on a consolidated return for that prior period and to the extent utilized prior to the closing it should not be available to the target company following the closing.[9]

The result would be similar if the target prior to the closing was a corporation covered by an S election. Under the S corporation rules, the income and deductions of an S corporation that appear on its return for a particular year pass through to the stockholders of the corporation at that time and do not thereafter appear on any subsequent return filed by the corporation.[10] In other words, deductions that were properly accrued prior to the closing may not be available to the target company after the closing if the target company was covered by a consolidated return through the closing or if it was covered by an S election through the closing. The result is similar if the target was a limited liability company or other entity which is subject to "pass through" taxation.

Even if the target was a C corporation through

6 Federal Tax Coordinator, Second Edition PL-5404, SUCCESSOR'S CONTINGENT LIABILITIES- REOGANIZATION EXPENSES AS NONDEDUCTIBLE CAPITAL EXPEDNITURES (2012).

7 The Federal Tax Coordinator article described above, provides that while some of the decisions, including the Seventh Circuit in its opinion in *Illinois Tool Works*, infra at note 8, have observed that it might be possible in some situations for the assumption of a contingent liability by the buyer as part of an acquisition to give rise to a deduction (and not have to be capitalized) none of the decided cases have allowed a deduction for an assumed liability and none of them have described those situations where an assumed liability would be give raise to a deduction.

8 *Holdcroft Transp. Co. v. Comm.*, 153 F2d 323 (C.A. 8, 1946); *Pacific Transport Company v. Comm.*, 483 F2d 209 (C.A. 9, 1973), cert. denied, 415 U.S. 948 (1974); *Illinois Tool Works v. Comm.*, 117 T.C. 39 (2001) *aff'd* 355 F.2d 997 (C.A. 7, 2004).

9 Section 1.1502-21(b)(2)(ii), Income Tax Regulations.

10 Section 1366(a) of the Code.

the closing and was not included on a consolidated return covering the seller's affiliated group, the target's ability to claim a deduction could also be reduced or eliminated by operation of the net operating loss carryover and the built-in loss rules of section 382 of the Code. These rules restrict the ability of a target corporation, in any year after there has been a prohibited change in the ownership of the target, to utilize net operating losses and built-in losses that were in place at the time of the change in ownership. A prohibited change in ownership will generally occur if over any three year period there is a shift in the ownership of more than 50% of the outstanding stock of the target corporation and the Section 382 rules apply once that threshold has been exceeded. Those rules in general restrict on an annual basis after the prohibited change in ownership (*i.e.*, the closing) the target's ability to utilize those net operating loss carryovers and built-in losses that were in place at the closing to the value of the target at the time of the change in ownership times the long term tax-exempt interest rate.[11] In December of 2012, the long term tax exempt rate was approximately 2.83%.[12] The authors believe (admittedly without the support of empirical data) that the vast majority of merger and acquisitions that take place each year in the United States involve the single year transfer of more than 50% ownership of target enterprises. Accordingly, the built-in loss rules could, depending on the value of the target at the time of the closing, minimize the potential tax benefits available to most buyers of C corporation targets.

In short, a potential tax windfall can in general only be available to a buyer or a buyer subsidiary in a taxable Stock Deal without significant risk if the target meets two conditions: (a) the target had been a "free standing" individually taxed entity (*i.e.*, not part of seller's consolidated group); and (b) the target is a C corporation. And even if the target is such a C corporation, any deduction opportunity could be severely limited by the built-in loss rules. If the target was an "S corporation" or other pass-through entity, no deduction or "windfall" should be available to buyer. Thus, in the case of Stock Deals, the potential of a tax benefit windfall to the buyer may be rare.

Conclusion of Tax Analysis

As presented in its oversimplified form, the sellers' basic argument certainly has some visceral appeal. However, in the case of a Stock Deal, the argument suffers significant weakness and limitation. In the case of an Asset Deal the argument has even less merit. The authors believe that it may not be an overstatement (or at least it is a forgivable overstatement) to say that the tax benefit windfall is in most transactions elusive if not mythical. As in many situations, things are not as simple as they seem, especially when advocated by a party with an axe to grind. The above technical tax analysis should galvanize buyers to completely reject such tax benefit offset arguments in negotiations. The analysis should also give pause to sellers and their attorneys in making such arguments (although that might be less likely to happen in the near future).

Buyers' Non-Tax Counter Arguments

Buyers could be expected to resist any provision that would complicate, delay, or obstruct a full measure of recovery should there be a breach of representation or covenant under the acquisition agreement. Clearly, the imposition of a provision intended to reduce that recovery by a consideration that involves reference to a body of laws, rules, and regulations as complex as corporate income taxes, potentially compounded by a separate body of accounting rules and practices, could be expected to meet fierce resistance from buyers. In addition to the tax analysis which undercuts the seller's basic fairness argument in many instances it would appear that buyers would have many legitimate non-tax bases of opposition to such tax benefit reduction proposals by sellers.

Undesirable Disclosure of Buyer Sensitive Information

Any indemnification regime which takes account of the supposed actual tax benefits to the buyer naturally puts the buyer's tax position, tax reporting, and tax strategy in issue. Such provisions expose the very private tax considerations of the buyer and possibly its affiliates to the prying eyes of an adversary. Certainly, such buyer tax matters become fair game in discovery if there are disputes arising from indemnification claims. Tax returns contain a great deal of sensitive information which companies normally carefully protect from all eyes other than the Internal Revenue Service or the relevant state tax authorities. For example, corporate tax reports must disclose controversial tax positions; state tax returns could indicate where the buyer has its sales force; pricing of product to foreign affiliates can be gleaned from tax return schedules; license fees charged can be determined

11 Section 382(a) of the Code.

12 Rev. Rul. 2012-31, 2012-49 I.R.B. 636.

from foreign tax credits that are reported; compensation paid to key executives would be disclosed. There may be many other examples which are beyond the scope of this article. Many CFOs or directors of taxation would likely be aghast at the prospect of an adverse party having the right to rummage through its tax strategies and reporting positions or possibly having a seat at the table if the IRS disputed the buyer's ability to claim the so-called tax "windfall." The risks of undesirable disclosure of a tax matter could certainly deter an aggrieved buyer from seeking indemnification.

Perverse Result

The imposition of the burden on the buyer to disclose its tax situation to the party that is responsible for the damage arising from the breach appears to be punishing the injured party for the benefit of the "wrong-doer." It is difficult to sympathize with the seller who asserts unfairness or inequity because the seller doesn't get to enjoy the alleged windfall tax benefit to the buyer. The situation is somewhat analogous to the plea of the "orphan" who has murdered its parents.

Serendipitous Timing

A buyer might point out that the measure of recovery on account of an adverse event or circumstance that would give rise to or constitute a breach should not vary depending on *when* the adverse circumstance is discovered. If such a circumstance was discovered prior to the time a definitive agreement is executed it might be reflected as a price adjustment demanded by the buyer that would most likely not take tax effect into account. In fact, a buyer might even apply a multiple of the gross adverse effect in its calculus of the price adjustment it would want based on the typical pricing formula based on a multiple of earnings or EBITDA. The same price adjustment demand could be made even if discovery occurs after the definitive agreement has been executed if the breach would permit the buyer to decline to proceed to closing. The comparison of the potential robust measure of recovery if a breach circumstance emerges earlier in the transaction process to a highly restricted and reduced recovery if the breach is not discovered until after closing illustrates the extreme and unjustified disparity between the compensatory results available to a buyer from the same adverse circumstance due *solely* to timing of discovery.

A buyer might also posit the situation where an adverse circumstance is picked up during the typical post closing price adjustment audit or other determination process in which a common metric is working capital. No consideration of tax benefit to the buyer is customary at that stage of the acquisition process. Why should it be different if the discovery occurs subsequent to the post-closing audit of working capital? Should the buyer be so unlucky just because of timing of discovery?

Complexity

Then there is the legitimate issue of complexity, not in the drafting of the tax benefit provisions of the agreement (which are generally "short and sweet" as discussed below), but in their implementation. Not all situations are as simple as an undisclosed ordinary and necessary business expense. What about a breach due to an over-valued capital asset? In all situations, what threshold should be established to prevent the seller from arguing that the buyer should adopt an unsustainable tax position? Should the decision about claiming a tax benefit rest with the buyer and its accountants or should it be conditioned on the buyer receiving a clean opinion from competent tax counsel that it will prevail if it claims the tax benefit and that position is challenged by the IRS? When should the agreement provide that the tax benefit was realized? Is the buyer sufficiently aggressive in its reporting? When does a taxpayer know that its reporting position is no longer subject to challenge by the IRS or foreign, state, and local taxing authorities? Should the buyer and seller be tethered to each other for the duration? When should the seller be given the benefit of the tax "windfall," at the time the indemnification payment is due or after the expiration of the relevant statute of limitation on auditing the return(s) where the buyer claimed that tax benefit? If the tax position is challenged, should the seller be responsible for the costs to defend the position and should it have any role in the audit or the appeal if there is an adverse determination?

Complexity in implementation applies also to the costs to the seller in achieving an alleged tax benefit. How are countervailing tax detriments reflected?

Such complexity in the implementation is of course advantageous to the seller. Anything that inhibits the buyer in seeking indemnification is a plus for the seller.

Sellers' Tax Benefits

The sellers' fairness/windfall argument also ignores the fact that sellers also obtain a tax benefit in

that the sellers' income or gain from the acquisition is reduced upon the making of indemnification payments.

Current State of Play

Decades ago, efforts to include tax benefit offset provisions were easily dismissed, derided as another example of sellers' gimmickry.[13] However, what had once been thought to be rare (perhaps because of perceived complexity of such provisions,[14] among other objections buyers and their counsel might naturally have) appears to have become much more prevalent.

It is evident from the results of the 2011 Private Target Mergers & Acquisitions Deal Points Study (the "2011 Study")[15] and prior studies that buyers' counsel agree, with considerable regularity, to the inclusion of indemnification provisions which reduce indemnification payments by the tax benefit actually realized by the buyer or the target business. In the 2011 Study, tax benefit offset provisions appeared in 53% of the relevant transactions (50 out of 95).[16] Prior years' studies[17] indicated such provisions in over 30% of each of the applicable samples. Indirect evidence of the recent "respectability" of tax benefit provisions can also be seen in the inclusion of such provisions in form or prototype stock purchase documents characterized not only as "pro-seller"[18] but also as "neutral"[19] by a leading M&A treatise.

2011 Deal Language

A review of all of the acquisition agreements in the 2011 Study which reduced or offset a buyer's indemnification payments by the supposed tax benefit yields the following observations:

Slightly more than 40% of the agreements documented Asset Deals, while slightly more than 60% of the agreements documented Stock Deals. Only one agreement documented a tax-free reorganization. The documentation regarding the Asset Deals and the Stock Deals do not reflect any discernible trends or distinctions as to how the tax benefit offset language is formulated. Nor did the documentation regarding the tax-free reorganization reflect a departure from the taxable deals.

Almost all of the agreements in the sample employed relatively simple and economic phrasing consisting of some variation of the "net tax benefit actually realized by the buyer or the acquired business."

About half of the documents either expressly provided for or strongly implied that the indemnification payment by seller be made initially on a gross dollar-for-dollar basis with the buyer being obligated to reimburse the seller after the net tax benefit was actually realized. The other half leaves the question open, although it would appear that even without contractual direction such a sequence would tend to eventuate. None of the 50 agreements expressly addressed the timing of tax benefit realization/indemnification reduction as it relates to an escrow intended to provide the fund for indemnification payments.

Only one document called for a present value calculation and specified the interest (discount) rate and a specified assumed tax rate (of 38%).

There were some instances of limitations on the tax benefits that could be counted as a reduction of the indemnification payment. Seven acquisition agreements required that the tax benefit be realized within specified time periods; and two agreements directed that the alleged tax savings item be the last to be considered in the tax benefit calculation (for example, net operating losses of buyer would be used first).

Seven deals applied an express loss mitigation obligation on buyer that would appear to apply to the reduction of damages based on tax benefits, suggesting that buyer may have an obligation to maximize tax benefits.

In one deal, buyer was expressly required to provide documentation of the benefit reasonably requested by seller and in another buyer was actually required to produce its tax return.

Only one acquisition agreement out of the entire

13 James Freund, Anatomy of a Merger (1975), pp. 376-8.

14 Kling & Nugent, Negotiated Acquisitions of Companies, Subsidiaries and Divisions (2012), Section 15.03 [2]; American Bar Association, Revised Model Stock Purchase Agreement, 2nd Edition (2010) Commentary page 311.

15 2011 Private Target Mergers & Acquisitions Deal Points Study, A Project of the Mergers & Acquisitions Market Trends Subcommittee of the Mergers & Acquisitions Committee of the American Bar Association Business Law Section, https:/apps.americanbar.org/dch/committee.cfm?com=CL560003.

16 Slide 109 of 2011 Study.

17 *Id.*

18 Ginsberg & Levin, Mergers, Acquisitions and Buyouts (September 2011). Ch. 22, p. 22-119.

19 *Id.* at p. 22-185.

sample contained a provision which protected the buyer from an "audit or other investigation" by the seller. Except for this single exception among the 50 deals in the 2011 Study, the buyers could face at least some undesirable exposure of their tax returns and their tax reporting strategies should they seek indemnification for breaches of representations. None of those 49 other deals placed any contractual limit on what a seller could demand to see about buyers tax situation in a dispute regarding indemnification.

Absence of Effective Pro-Buyer Protections

The 2011 Study documentation is surprising not only because of the predominance of pro-seller tax benefit offset provisions, but also for the absence of effective protection of the buyer within the affected agreements. While there were almost 10 transactions which limited the time periods during which creditable tax benefits could be realized, specified that items arising from a breach be the last to be recognized in the tax benefit calculation, or denied the seller an "audit or investigation" of buyer's tax determination, there was not a single instance in which buyer sought to: provide that it or its accountant unilaterally and conclusively make the tax benefit determination; disclaim any obligation to maximize or even seek tax benefits; or require that any buyer tax-related information obtained by seller be maintained in strict confidence.

All of the transactions in 2011 Study involve publicly-owned buyers and privately-owned sellers. As publicly-owned companies, buyers would presumably be represented by experienced and sophisticated legal counsel. It is difficult to reconcile that fact with the predominance of pro-seller tax benefit offset provisions and, more particularly, with the lack of pro-buyer protections.

Conclusion

The authors believe that the tax benefit offset argument in transactions involving either an Asset Deal or a Stock Deal is a "red herring" that sellers and their legal counsel make and buyers and their legal counsel routinely accept without a real understanding of the argument's weakness or its potential for mischief to the buyers. The authors are also of the opinion that commentators that directly or indirectly endorse or support the sellers' tax benefit offset argument[20] are simply incorrect on the law and the possible risks that can be forced on the buyer. Buyers have ample reason to oppose, based on a superior legal tax-based argument, any effort by sellers to seek (however fruitless the pursuit might turn out to be) a reduction in sellers' liability based upon how the buyers might report their income taxes. Furthermore, buyers have ample forceful non-tax arguments upon which to base their opposition. While sellers and their counsel have every reason to throw as many obstacles as possible in the way of buyers recovery for breach of representation, buyers in taxable Asset Deals and taxable Stock Deals should be uniformly deflecting or defeating the tax benefit offset gambit.

20 Kling & Nugent, supra note 13; Ginsberg & Levin, supra note 16.